

**CONCERNS WITH CHINA'S PROPOSED RULES ON GOVERNMENT
PROCUREMENT OF SOFTWARE**

**Prepared Statement of
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**House Government Reform Committee
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Chairman Davis, ranking member Waxman, members of the Committee, thank you for giving me the opportunity to testify today.

When China joined the World Trade Organization (WTO) in 2001, it agreed to conduct its government procurement transparently. China became an observer to the WTO Agreement on Government Procurement (GPA) in 2002 and pledged to begin the process of joining the GPA as soon as possible. Accordingly, we expect China's procurement rules in the interim to move it closer to the principles of the GPA.

In November of last year, China released a summary of draft regulations on the procurement of software that raised important questions about China's commitment to the spirit of the GPA. American business and government expressed strong opposition to the rules described in the summary, but the concerns of US companies were not addressed in the fuller draft regulations released in March 2005. As currently written, the regulations are a key concern for many of the US-China Business Council's approximately 250 member companies, which are engaged in all manners of business—some in software, but others who look at this as an indication of China's government procurement practices more generally.

We applaud the Chinese government for its transparency in releasing the proposed rules for public comment; this is indeed a step forward. However, we have significant concerns that the new rules are a step backwards for China's procurement regime. Our specific issues are twofold. First, the software rules would essentially block American companies from competing on an equal basis with Chinese firms for PRC government contracts for software products and services. Second, the software rules could set a precedent for future discriminatory procurement policies.



Summary of the Proposed Rules

The Implementing Measures for Government Procurement of Software are based on the PRC Government Procurement Law and lay out guidelines for the certification of domestic software and services. The measures also create a list of preferred non-domestic software and service providers. Essentially, the implementing measures would require PRC government entities to purchase “domestic software products” and “domestic software services” unless they receive a special waiver from the Ministry of Finance and Ministry of Information Industry to buy from a select group of international companies listed in a *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference*.

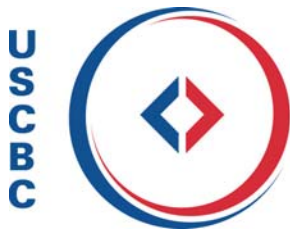
To be considered a “domestic software product,” software must meet certain requirements:

- The software must be developed within China;
- The copyright for the software must be held by natural person(s), legal person(s), or other organizations within China;
- Development costs incurred in China must account for at least 50 percent of total costs of the software.

“Domestic software services” is defined as computer information system integration, information system engineering supervision, and other related professional technical services provided by natural person(s), legal person(s), or other organization(s) in China. International companies may work with providers of “domestic software services,” but the value contributed by the foreign side may not exceed 30 percent of the total value of the project.

Based on the letter of the law, these definitions suggest that Chinese subsidiaries of international companies could, in theory, compete for software procurement contracts if they satisfied the requirements I have described.

Non-domestic software providers—that is, American or other international software suppliers that do not have subsidiaries in China—may apply to the China Software Industry Association—an industry association with a vested interest in China’s domestic industry, not a government entity—for one-year inclusion in the *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference*, with final approval required by the Ministry of Information Industry. To qualify for a listing in the catalogue, non-domestic software providers must be able to provide software services (such as support and after-sales service) in China and also meet certain investment and revenue



THE US-CHINA BUSINESS COUNCIL

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requirements for their operations in China. These requirements are not defined in the draft.

In order to purchase non-domestic software, the government customer additionally must seek the approval of the Ministry of Finance, which will consult with the Ministry of Information Industry on the request. These requests must be submitted for each proposed purchase of a non-domestic software product or service.

Finally, the rules also suggest a preference for open-source software.

Problems with the Rules

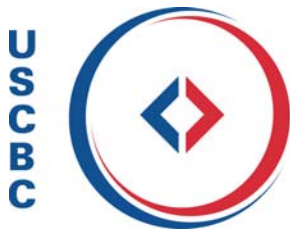
These rules contain a number of concerns.

On a technical level, the rules appear to contradict open procurement principles by effectively prohibiting access by international software providers to the PRC government market. The definitions of “domestic software products” and “domestic software services” are restrictive to a point that even those international companies with PRC subsidiaries, manufacturing facilities, and large levels of investment in China might be unable to qualify their products as “domestic” as that term is defined in the proposed rules.

As I mentioned before, to be certified as “domestic,” the software product must meet three requirements: it must be developed in China; a Chinese entity must hold its copyright; and half the cost of the software must be development costs incurred in China. Software, however, is not created in any one country. Software companies operate research centers and employ programmers who work collaboratively with colleagues in multiple countries. Also, today’s software is often based on older programs written years ago.

To meet the “domestic” criteria, software companies would likely have to create entirely new products using programming code written only in China. This is an unreasonable demand. Since the rules in effect would therefore grant an absolute preference to domestic products and services, this amounts to a prohibition on the procurement of products developed and distributed by international suppliers.

Furthermore, placement of a product on the *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference* appears to give international companies only the most minimal level of market access. PRC government entities will only be allowed to purchase software listed in the Catalogue if there is no domestic substitute



THE US-CHINA BUSINESS COUNCIL

美中贸易全国委员会

and if they obtain a waiver from the relevant ministries. These are highly restrictive requirements, and the proposed rules will therefore effectively block international software companies from competing in the PRC government procurement market on an equal basis with Chinese suppliers.

Many countries, including the United States, grant domestic firms some form of preference in government procurement contracts. These, however, are almost always accompanied by cost thresholds or other mechanisms that limit the use of such preferences. For example, when a contract is valued at more than the specified threshold, no preferences are awarded to domestic goods.

In contrast, the PRC's proposed software procurement rules set out an absolute preference for domestic goods. There are no general circumstances described in the proposed rules in which an international company would enjoy the same access to the PRC government software market as a domestic supplier.

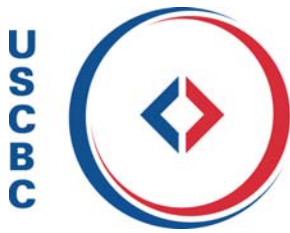
When this absolute preference is combined with the highly restrictive definition of "domestic software," the proposed rules essentially block international companies from competing for PRC government procurement contracts. As such, the proposed rules clearly do not conform to the requirements of the World Trade Organization (WTO) Government Procurement Agreement (GPA), which China has said it intends to sign.

Moreover, the preference for open-source software distributed by Chinese suppliers would exclude competing products that are based on the development or licensing model. This preference runs counter to the fundamental international practice of merit-based procurement, which is recognized in several GPA principles. These principles include the requirement that technical specifications in procurement rules be specified in terms of performance characteristics and similar function-based criteria.

Recommendations

We were greatly encouraged by the Five Principles for US-China Trade proposed by Premier Wen Jiabao during his visit to the United States in December 2003. Premier Wen called for the expansion of US exports to China to help reduce the US trade deficit. Premier Wen also said the US-China trade relationship should be based on the principles of mutual benefit and that each side should consider the effects their policies have on the other.

We would be disappointed to see China implement policies that would greatly limit American access to its government procurement market for software at such a critical



THE US-CHINA BUSINESS COUNCIL

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time in the US-China trade relationship. We need more opportunities for US companies to sell products to China, not less. Access to the PRC government procurement market for software is exactly the type of “win-win” outcome of significant mutual benefit that Premier Wen spoke of in 2003. Now more than ever, it is important for China to demonstrate its commitment to increasing its imports from the United States and to a rules-based trading system.

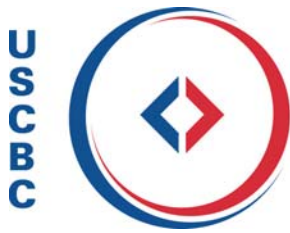
We strongly support the PRC government’s stated intention to join the GPA at the earliest possible time and in the meantime to encourage the development of rules consistent with the GPA. To be consistent with its stated intentions, the US-China Business Council has asked the PRC government to suspend further action on these rules until they can be discussed in full at the US-China Joint Commission on Commerce and Trade (JCCT) meeting to be held in Beijing in the next month or two.

We understand that the proposed rules will be a key part of the US agenda at this year’s JCCT meeting and we look forward to working with Secretary of Commerce Carlos Gutierrez, US Trade Representative Rob Portman, and their staffs to ensure a successful resolution of this issue. We encourage USTR and the Department of Commerce to:

- Secure commitments from Beijing to shelve the software procurement rules, or to revise them to address the concerns of American businesses and conform to international best practices;
- Establish a time-table for China to sign the GPA and work to reinvigorate China’s commitment to do so; and
- Seek China’s agreement to delay in the meantime further progress on all other procurement regulations not in conformity with the GPA.

Through formal and informal channels, the US-China Business Council has stressed to the PRC government the benefits of having access to the best possible software at the best value—and that this requires open procurement. China is rightly interested in encouraging technological development and innovation, but this can best be done through greater competition and more openness to new technologies. American business and government must oppose measures that use of discriminatory policies to achieve these goals.

Thanks to the work of the Department of Commerce and USTR, and to the efforts of those in the Chinese government who understand the benefits and importance of open trade policies, China’s leaders have previously revised policies that would have imposed significant restrictions on the ability of American companies to compete in



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China. Agreements between China and the United States on China's value-added tax rebate for domestically manufactured semiconductors and on the proposed WAPI (Wireless Authentication and Privacy Infrastructure) wireless network standard are encouraging signs that the American government and business community can work successfully with China to correct discriminatory policies to the benefit of both sides.

As we firmly resist the proposed software procurement rules and any other attempts to use procurement policy to block American companies from competing in China, we should look to these previous successes as examples of the robust engagement that has convinced China to adopt more reasonable policies. This should again be our policy as we work to secure China's agreement to revise the software procurement rules.

Thank you Mr. Chairman and Congressman Waxman. I am happy to answer any questions you or other members of the Committee may have.